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Consideration of the Internal Control Structure in a Financial Statement Audit

(Supersedes Statement on Auditing Standards No. 1, AICPA, Professional Standards, *vol. 1, AU sec. 320.)**

CONTENTS OF STATEMENT

*This Statement also supersedes SAS No. 1, *The Auditor's Study and Evaluation of Internal Control: Auditing Interpretations of AU Section 320* (AICPA, *Professional Standards*, AU sec. 9320.01-.06).

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1. This Statement provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards.[1] It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

SUMMARY

2. An entity's internal control structure, for purposes of this Statement, consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

3. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

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[1]This Statement revises the second standard of fieldwork of the ten generally accepted auditing standards as follows:

> A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

4. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

5. The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

STATEMENT

Elements of an Internal Control Structure

6. An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Although the internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an audit of the entity's financial statements. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements.[2] Other policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.

7. An entity generally has internal control structure policies and procedures that are not relevant to an audit and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-

[2]The terms *financial statement assertions* and *assertions* are used throughout this Statement to refer to the five categories of management's assertions that are embodied in the account balance, transaction class, and disclosure components of financial statements as discussed in paragraphs 3 through 8 of Statement on Auditing Standards No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.03-.08).

making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit.

8. For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

Dividing the internal control structure into these three elements facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

Control Environment

9. The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- The functioning of the board of directors and its committees, particularly the audit committee
- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following up on performance, including internal auditing
- Personnel policies and practices
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies

The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. (The control environment factors are discussed in greater detail in appendix A.)

Accounting System

10. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will —

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Control Procedures

11. Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to —

- Proper authorization of transactions and activities.
- Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.

- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

General Considerations

12. The applicability and importance of specific control environment factors, accounting system methods and records, and control procedures that an entity establishes should be considered in the context of—

- The entity's size.
- Its organization and ownership characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

For example, a formal written code of conduct or an organizational structure that provides for formal delegation of authority may be significant to the control environment of a large entity. However, a small entity with effective owner-manager involvement may not need a formal code or organizational structure. Similarly, a small entity with effective owner-manager involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding procedures.

13. Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that an entity's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

14. The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship

is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

15. The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the policies and procedures that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies or procedures.

Consideration of the Internal Control Structure in Planning an Audit

16. The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to —

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

17. Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies, procedures, or records have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

18. The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

19. In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessments of inherent risk, his judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to obtain the understanding of them that is necessary to design effective substantive tests. For example, when auditing past due loans of a financial institution that uses computer-produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans.

Understanding of Control Environment

20. The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but

not act on them. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

Understanding of Accounting System

21. The auditor should obtain sufficient knowledge of the accounting system to understand —

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

Understanding of Control Procedures

22. Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

23. In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures.

24. For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they have been placed in operation. Similarly, in obtaining an understanding of the design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedure design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

25. The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

26. The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Consideration of the Internal Control Structure in Assessing Control Risk

27. Statement on Auditing Standards No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

28. The risk of material misstatement[3] in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

29. Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.[4]

30. Assessing control risk at below the maximum level involves—

- Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Performing tests of controls to evaluate the effectiveness of such policies and procedures.

31. In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion,

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[3] For purposes of this Statement, a material misstatement in a financial statement assertion is an error or irregularity as defined in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, that either individually or when aggregated with other errors or irregularities in other assertions would be material to the financial statements taken as a whole.

[4] Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this Statement to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

32. Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

33. Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than policies and procedures more directly related to that assertion, such as matching shipping documents with billing documents.

34. Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the audi-

tor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

35. Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

36. The conclusion reached as a result of assessing control risk is referred to as the *assessed level of control risk*. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs 46 through 60. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

37. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this Statement as substantive tests.

38. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.

- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

Documentation of the Assessed Level of Control Risk

39. In addition to the documentation of the understanding of the internal control structure discussed in paragraph 26, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

Relationship of Understanding to Assessing Control Risk

40. Although understanding the internal control structure and assessing control risk are discussed separately in this Statement, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure (discussed in paragraphs 23 through 25) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs 34 through 35) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

41. Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to

perform some tests of controls concurrently with obtaining the understanding of the internal control structure. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. For example, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

42. When the auditor concludes that procedures performed to obtain the understanding of the internal control structure also provide evidential matter for assessing control risk, he should consider the guidance in paragraphs 46 through 60 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level for certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a policy or procedure relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

43. After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further

reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

44. In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

45. For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Evidential Matter to Support the Assessed Level of Control Risk

46. When the auditor assesses control risk at below the maximum level, he should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads, all bear on the degree of assurance evidential matter provides.

47. These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a policy or procedure that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

48. The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies and procedures. For some policies and procedures, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

49. For other policies and procedures, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or some control procedures performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

Source of Evidential Matter

50. Generally, evidential matter about the effectiveness of the design and operation of policies and procedures obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control procedure generally provides more assurance than making inquiries about that individual. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present.

51. Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure. When the auditor determines that a specific control procedure may have a significant effect in reducing control risk to a low level for a specific assertion, he ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control procedure.

Timeliness of Evidential Matter

52. The timeliness of evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of internal control structure policies and procedures for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control procedure performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the program executes the control effectively. The auditor may then perform tests of controls directed toward the design and operation of other control procedures pertaining to the modification and the use of that computer program during the audit period to obtain evidential matter about whether the programmed control procedure operated consistently during the audit period.

53. Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the prior audits, the degree to which the effective design and operation of those policies and proce-

dures were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

54. When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

55. When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the interim period, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive tests performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

56. The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to

evaluate the effective design or operation of an internal control structure policy or procedure. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

57. In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion.

58. Generally, when various types of evidential matter support the same conclusion about the design or operation of an internal control structure policy or procedure, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of an internal control structure policy or procedure, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, he may reevaluate his conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

59. Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective accounting system or control procedure for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the

program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

60. An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

Correlation of Control Risk With Detection Risk

61. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

62. After considering the level to which he seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the

assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

63. Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

64. The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

Effective Date

65. This Statement is effective for audits of financial statements for periods beginning on or after January 1, 1990. Early application of the provisions of this Statement is permissible.

Appendix A

Control Environment Factors

1. This appendix discusses the control environment factors identified in paragraph 9.

Management Philosophy and Operating Style

2. Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting; and management's emphasis on meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

Organizational Structure

3. An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee

4. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

Methods of Assigning Authority and Responsibility

5. These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

Management Control Methods

6. These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Internal Audit Function

7. The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.*

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*SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination* (AICPA, *Professional Standards,* vol. 1, AU sec. 322), provides guidance about factors that affect the auditor's consideration of the work of internal auditors in an audit.

Personnel Policies and Practices

8. These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences

9. These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

Appendix B

Glossary of Selected Terms and Concepts

Accounting system The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

Assertions Management representations that are embodied in the account balance, transaction class, and disclosure components of financial statements. They include (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation, and (5) presentation and disclosure.

Assessed level of control risk The level of control risk the auditor uses in determining the detection risk to accept for a financial statement assertion and, accordingly, in determining the nature, timing, and extent of substantive tests. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level.

Assessing control risk The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

Control environment The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

Control procedures The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

Detection risk The risk that the auditor will not detect a material misstatement that exists in an assertion.

Inherent risk The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

Internal control structure The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

Internal control structure policies and procedures relevant to an audit The policies and procedures in an entity's internal control structure that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

Maximum level of control risk The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Operating effectiveness How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom.

Placed in operation An entity is using an internal control structure policy or procedure.

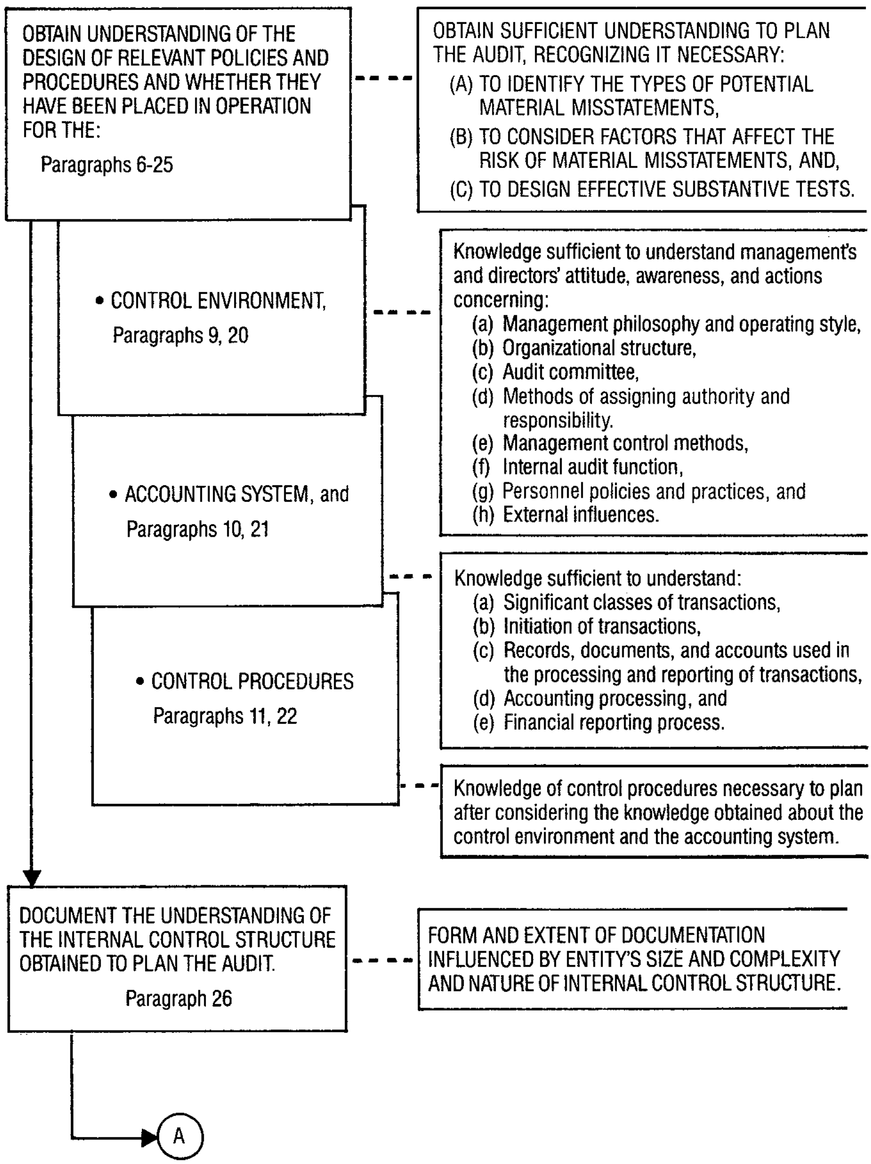
Substantive tests Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

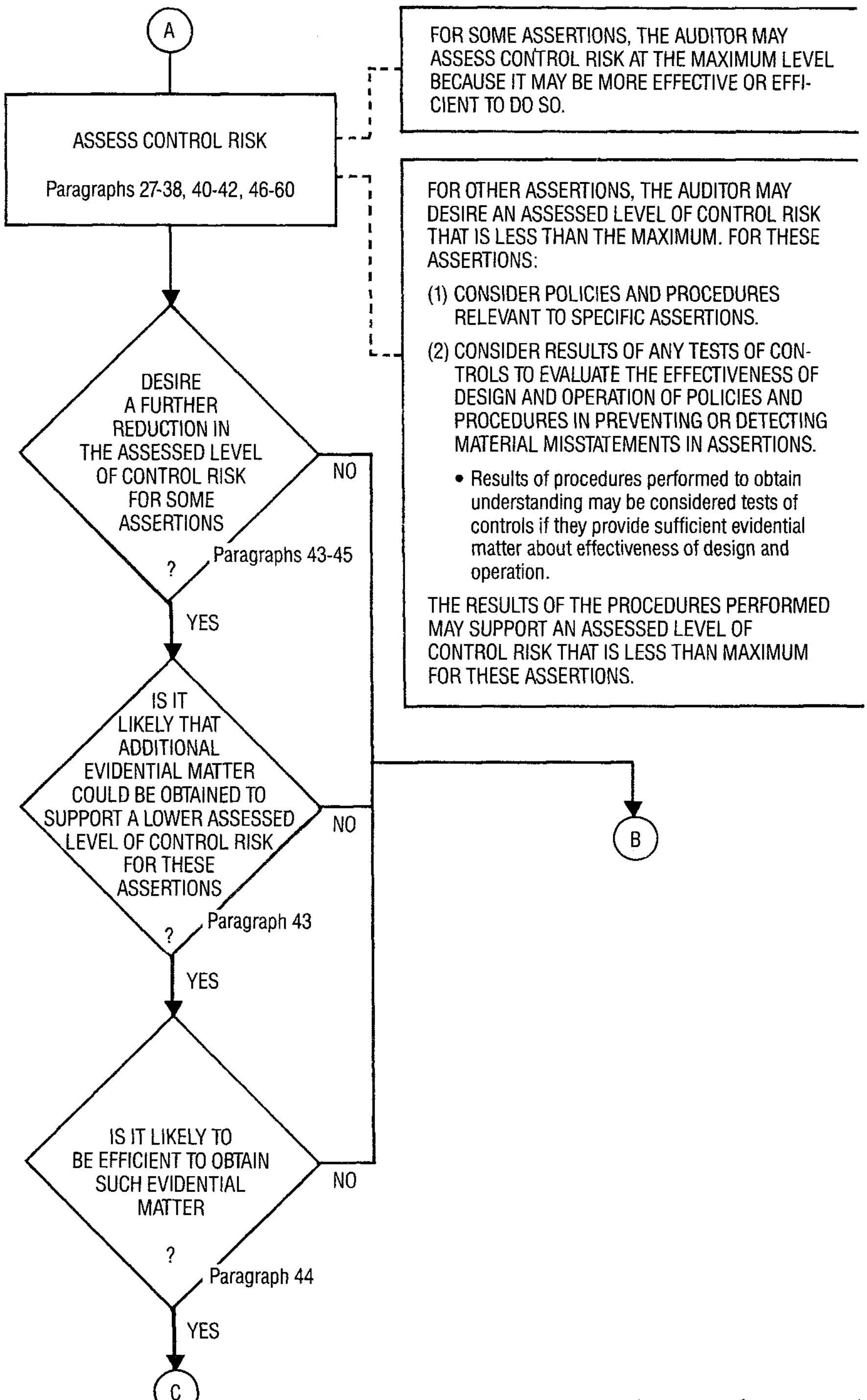
Tests of controls Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

Understanding of the internal control structure The knowledge of the control environment, accounting system, and control procedures that the auditor believes is necessary to plan the audit.

Appendix C

FLOWCHART
CONSIDERATION OF THE INTERNAL CONTROL
STRUCTURE IN A FINANCIAL STATEMENT AUDIT





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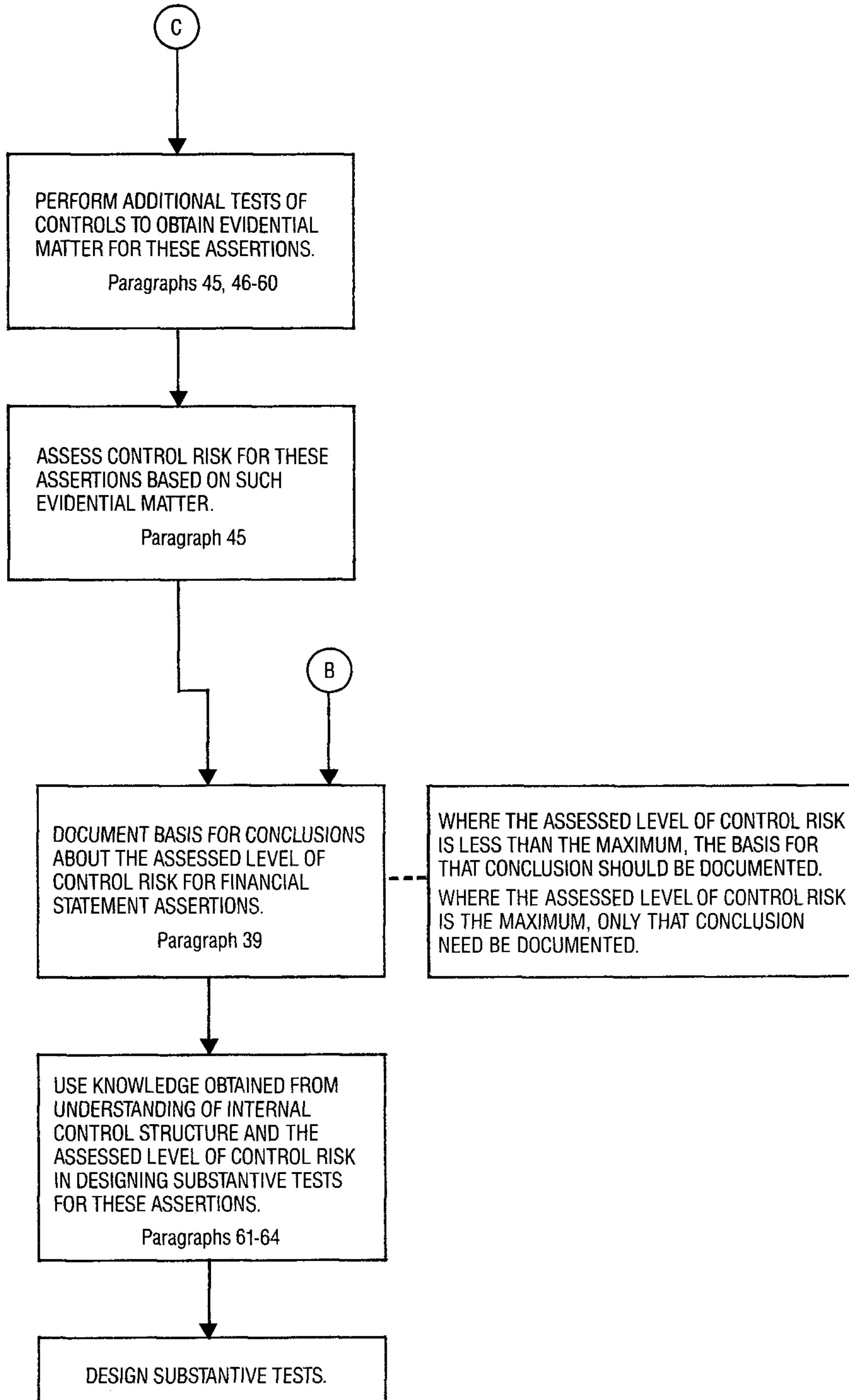
C
PERFORM ADDITIONAL TESTS OF CONTROLS TO OBTAIN EVIDENTIAL MATTER FOR THESE ASSERTIONS.
Paragraphs 45, 46-60
ASSESS CONTROL RISK FOR THESE ASSERTIONS BASED ON SUCH EVIDENTIAL MATTER.
Paragraph 45
B
DOCUMENT BASIS FOR CONCLUSIONS ABOUT THE ASSESSED LEVEL OF CONTROL RISK FOR FINANCIAL STATEMENT ASSERTIONS.
Paragraph 39
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS LESS THAN THE MAXIMUM, THE BASIS FOR THAT CONCLUSION SHOULD BE DOCUMENTED.
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS THE MAXIMUM, ONLY THAT CONCLUSION NEED BE DOCUMENTED.
USE KNOWLEDGE OBTAINED FROM UNDERSTANDING OF INTERNAL CONTROL STRUCTURE AND THE ASSESSED LEVEL OF CONTROL RISK IN DESIGNING SUBSTANTIVE TESTS FOR THESE ASSERTIONS.
Paragraphs 61-64
DESIGN SUBSTANTIVE TESTS.

Appendix D

Other Selected Management Control Objectives

1. The concepts and terminology introduced in this Statement clarify and update former SAS No. 1, *The Auditor's Study and Evaluation of Internal Control* (AICPA, *Professional Standards,* vol. 1, AU sec. 320), by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established by Statements on Auditing Standards issued subsequent to that SAS. This appendix discusses some of the basic concepts in SAS No. 1 that are implicit in an internal control structure but that are not explicitly discussed in this Statement. Although these concepts have general application, the organizational and procedural means for applying them may differ considerably from case to case because of the variety of circumstances involved.

Management Objectives

2. Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Access to Assets

3. The objectives of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both

direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum feasible constraint. The number and competence of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices.

Comparison of Recorded Accountability With Assets

4. The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

5. If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded transactions. The converse, however, does not necessarily follow. For example, agreement of cash count with the recorded balance does not provide evidence that all cash received has been properly recorded.

6. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

7. As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

8. The frequency with which comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors and irregularities.

9. The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and

cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

The Statement entitled Consideration of the Internal Control Structure in a Financial Statement Audit *was adopted by the assenting votes of seventeen members of the board, of whom two, Messrs. Barber and Neebes, assented with qualification. Messrs. Barna, Clancy, Loebbecke and Ten Eyck dissented.*

Mr. Barber qualifies his assent to the issuance of this Statement because he believes the concept of a further reduction in the assessed level of control risk, starting in paragraph 43, is inconsistent with his perception of the audit process, wherein the auditor makes a preliminary assessment of the level of control risk based on his understanding of the internal control structure, gained primarily through his inquiry and observation procedures, and then performs audit procedures to validate that assessment if he intends to assess control risk at less than the maximum to restrict substantive tests. He also believes that the "further reduction" concept unnecessarily changes and confuses the well understood concept of "reliance on internal controls." Further, he believes that the Statement's relationship of the assessment of control risk directly to financial statement assertions is confusing, since he views the starting point for the auditor's control risk assessment as the relationship of controls to significant audit areas.

Mr. Neebes qualifies his assent because he believes the Statement fails to properly caution the auditor against placing undue reliance on the effectiveness of specific control procedures based solely on inquiry of client personnel and inspection of client-prepared documents. While he believes such procedures are important tests of controls, they ordinarily should not, in his opinion, be performed to the exclusion of reperformance or observation procedures if the auditor intends to assess control risk at a low level for a particular financial statement assertion. Mr. Neebes agrees with the statement in paragraph 50 that generally evidential matter obtained directly by the auditor provides more assurance than evidential matter obtained indirectly or by inference. He believes, however, that the implications of that statement should be explicitly stated in paragraph 51 in discussing the nature of tests ordinarily needed to conclude that a specific control procedure is effective in reducing control risk to a low level for a specific financial statement assertion.

Messrs. Barna, Clancy, Loebbecke, and Ten Eyck dissent because they have concerns that the Statement may not be consistently interpreted and appropriately applied in practice. They believe that the Statement should not be issued until it has been revised to resolve their concerns. Mr. Barna also believes that the Statement should have been re-exposed because, in his opinion, a number of significant changes were made to the exposure draft.

Mr. Clancy, in addition to his concern about the consistent interpretation and appropriate application of the Statement, believes that the Statement should increase responsibility regarding the auditor's consideration of an entity's internal control structure. He notes that the Statement includes two significant improvements to authoritative guidance by (1) recognizing that the auditor should obtain a sufficient understanding of each of the three elements of an entity's internal control structure to plan the audit, and (2) recognizing that, in obtaining that understanding, the auditor considers knowledge obtained from previous audits. He believes, however, that those responsibilities should be extended to require the auditor to review and evaluate, as contrasted with obtain a sufficient understanding of, each of the three elements of the entity's internal control structure that management uses in operating and controlling the business and that the auditor considers significant. He further believes that the Statement as written is overly complex and that several sound and long-established concepts, such as reliance on internal control and compliance testing, which are well understood by auditors and management and are comparatively easy to explain to others, should not be eliminated.

Mr. Ten Eyck, in addition to his concern about the consistent interpretation and appropriate application of the Statement, believes that the Statement is ambiguous regarding the relationship between the assessment of control risk and the reduced level of control risk based on evidential matter obtained from the understanding of the internal control structure. He also believes the Statement does not clearly distinguish the operating effectiveness of an internal control structure policy or procedure from the placing in operation of such a policy or procedure. He further believes that insufficient guidance is provided about the procedures in general that are necessary to arrive at valid conclusions about control risk and that, in particular, inquiry is not defined nor, in his opinion, is meaningful guidance provided about its use as an audit procedure.

Auditing Standards Board (1986–1987)

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